TABLE III-4
CURRENT RATES IN TEXAS

SOUTHWESTERN BELL

RATE GROUP	RES. SUB	BASIC RATE	TAX, 911,	TOTAL COST
1	331436	8.15	6.55	14.70
2	431335	8.35	6.55	14.90
3	398009	8.80	5.47	14.27
4	768404	9.10	6.91	16.01
5	511195	9.35	6.65	16.00
6	858102	9.85	6.63	16.48
7	647623	10.40	7.24	17.64
8	1058599	11.05	6.21	17.26
SWB	5004703	9.68	6.55	16.23
GTE	1040000	7.35	6.55	13.90
TOT	6044703	8.02	6.55	14.57

SOURCE: National Association of Regulatory Utility Commissioners, Bell Operating Companies Exchange Service Telephone Rates, December 31, 1994, for lines and basic rates for Southwestern Bell. Public Utility Commission of Texas, PUC Annual Report, Regulated Utilities in Texas and Texas Telephone Rates, for GTE and Continental. McMaster, Susan E. and James Lande, Reference Book: Rates, Price Indexes, and Household Expenditures for Telephone Service (Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, November 1995), Appendix 2 for Tax, 911, Touchtone. The statewide average is assumed for rate groups 1 and 2 and for GTE and Continental. The one percent of income number is $1 higher than that estimated by "Comments of Southwestern Bell Telephone Company," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, Attachment 4, to account for income growth from 1993 average to year-end 1994 income, which is the time period for the rates.

TABLE III-5:
INCOME AND TELEPHONE SUBSCRIPTION IN TEXAS

	% OF HH WITH A PHONE	BASIC SVC. AS A % OF MID POINT INCOME	% OF ALL HH W/O A PHONE	% OF ALL HH
LT 5000	67.28	7.0	26.90	5.65
5 TO 7499	74.66	2.8	18.78	5.65
7500 TO 9999	84.30	2.0	9.64	5.29
10000 TO 12499	87.05	1.6	9.14	6.28
12500 TO 14999	80.00	1.3	12.18	4.98
15000 TO 19999	89.53	1.0	9.14	7.99
20000 TO 24999	95.57	.8	4.57	10.06
25000 TO 29999	97.50	.6	2.54	10.11
30000 TO 34999	95.24	.5	4.06	8.30
35000 TO 39999	97.44	.5	1.52	5.91
40000 TO 49999	98.13	.4	1.52	8.14
50000 TO 59999	100.00	.3	.00	6.33
60000 TO 74999	100.00	.3	.00	6.07
75000 OR MORE	100.00	.2	.00	9.23
TOTAL	90.73	100.00	100.00	100.00

SOURCE: Bureau of the Census, Current Population Survey: November 1994, Washington, D.C., 1995

We can flip this observation around to note that the overwhelming majority of households without telephone service are low income households. For example, although only 12 percent of households have income below $7,500, we find that 45 percent of all those without telephone service are in this group. Moreover, although less than one quarter of all households have incomes below $15,000, over three quarters of all households without telephone service have incomes below this level.

Second, we have observed that only when the cost of service drops well below one percent of income in the aggregate does the telephone penetration rate begin to exceed high levels 95 to 100 percent. This is a demanding goal. For lower income groups, .7 percent of income is a relatively small figure, compared to average rates. For the lowest income category, 1 percent of income is only $1 to $3 per month. Even at the limit of poverty level income ($15000), 1 percent of income is just $12.50 per month, 15 percent less that current average rates in Texas.

E. CONCLUSION

It is clear that for households at the lower end of the income distribution, telephone service is simply not affordable by both measures of affordability -- the percentage of households without telephone service and the burden that having telephone service places on household budgets. Large percentages of households at this income level do not subscribe to service and those that do are forced to devote a disproportionately large share of their income to pay for basic service.

We recommend that the Commission adopt the long run goal of having just about all households (98 percent) in Texas subscribe to a comprehensive package of core service (as described in Table III-3) at rates that are just and reasonable and affordable to all subscribers. We believe that this will require policies to maintain affordable rates overall and allow lower income households, consumers with disabilities and consumers in high cost areas to purchase services at discounts that reduce the burden of those services to approximately .7 percent of income.

IV. RATE REBALANCING AND REVENUE REPLACEMENT ARE BAD ECONOMIC POLICY

A. AFFORDABLE SERVICE FOR ALL CONSUMERS

While much of the attention in the current universal service policy debate focused on subsidies and targeted programs, the Commission should never lose sight of the fact that universal service starts with just, reasonable and affordable rates for average citizens. In fact, the Commission's third question cuts right to the heart of the economic matter.

> 3. TO DETERMINE WHETHER UNIVERSAL SERVICE PROVISION HISTORICALLY HAS BEEN ACHIEVED BY LOADING MUCH OF THE COSTS OF LOCAL SERVICE PROVISION ONTO NON-RESIDENTIAL LOCAL AND LONG DISTANCE CALLING RATES, WILL IT FIRST BE NECESSARY TO DETERMINE WHAT ACTUAL SERVICE PROVISION AND SERVICE COSTS ARE?

It is absolutely critical to determine not only what the claimed costs of service are but also what the efficient cost of local service would be and what the joint and common costs across current and future services will be. Claims about the level and recovery of costs must be scrutinized with great care.

1. THE CONSUMER VIEW OF COST RECOVERY

The policies that have brought the state to a penetration rate over 90 percent were not the targeted programs that now receive so much attention; they were an approach to pricing basic service that kept it affordable. As noted earlier, there were two key components to this policy, keeping the overall revenue requirement under control by only allowing just and reasonable rates and by recovering as large a share as possible of joint and common costs from non-basic services.

The economic and regulatory underpinnings of this policy have not been altered by federal or state law. Just and reasonable is the law of the land, buttressed now by the addition of affordable. The fact that telecommunications service providers are contemplating the integration of more services into existing networks should only make it easier for Commissions to spread the fixed costs of the network to a growing body of network users and uses.

Above all, the Commission should view the loop (the wires that connect the end-user to the network and are used to complete all telephone calls -- local, intraLATA long distance, and interLATA long distance - and to provide enhanced services) as a shared facility.[17] If the loop were not provided by the existing local exchange companies, telecommunications service providers would have to build their own loops, or rent the use of some other loop in order to sell their services to the public. Because the loop is a joint and common cost shared by competitive and non-competitive services, it is subject to Section 254(k).

The language of section 254(k) could not be more precise -- basic service can bear, at most, a reasonable share of joint and common costs. Congress went well beyond a formal definition of cross-subsidy, however, to state a clear public policy preference for cost allocators when it required "cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

---

[17]Richard Gabel, The Impact of Premium Telephone Services on the Technical Design, Operation and Cost of Local Exchange Plant (Public Policy Institute, American Association of Retired Persons, 1992).

The Conference Report makes a point of stating that in adopting Section 254(k) the House is accepting the Senate language.[18] The Senate report made it clear that a reasonable share of joint and common costs was the maximum that should be included in the rates for universal service, but that less could be allocated to these services.

> The Commission and the states are required to establish any necessary cost allocation rules, accounting safeguards, and other guidelines to ensure that universal service bears no more than a reasonable share (and may bear less than a reasonable share) of the joint and common costs of facilities used to provide both competitive and noncompetitive services.[19]

The telecommunications network has always been typified by substantial joint and common costs between services -- including local, long distance and enhanced services. Sharing of joint and common costs is the linchpin of the 1996 Act. We believe that affordability can only be assured where there is a direct link between the expansion of utilization of the network -- the growth of information, data and video services -- and declining costs for basic access. As the network is filled up with enhanced and discretionary services, the cost of network access and plain old telephone service will decline for all people, if the link between use and basic service rates is well-crafted. In a sense, economies of scope -- the sharing of facilities between different services -- can play the role that economies of scale played in the early days of the industry.

---

[18]Conference Report, p. 134.

[19]Conference Report, p. 129.

It is not only consumer advocates who take this view of the loop,[20] but even some local companies point out charges for the use of the loop represent the recovery of joint and common costs.[21] State regulators also take this view.[22]

---

[20]"Comments of the National Association of State Utility Consumer Advocates," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter NASUCA), p. 17); "Initial Comments of the Office of the Ohio Consumers' Utility Counsel," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter OCC), p. 3; OPUC, Texas, p. 4.

[21]"Comments Bell Atlantic," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Bell Atlantic), p. 11-12 and NYNEX, p. 3.

[22]"Comments of the State of Maine Public Utility Commission, the State of Montana Public Service Commission, the State of Nebraska Public Service Commission, the State of New Hampshire Public Utilities Commission, the State of New Mexico State Corporation Commission, the State of Utah Public Service Commission, the State of Vermont Department of Public Service and Public Service Board, and the Public Service Commission of West Virginia" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Maine, et al.), p. 18; "Comments of the Idaho Public Service Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Idaho), p. 17); "Comments of the Public Utility Commission of Texas" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Texas), p. ii; "Initial Comments of the Pennsylvania Public Utility Commission to the Notice of Proposed Rulemaking and Order Establishing Joint Board" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Pennsylvania), p. 7.; Florida, p. 22; "Initial Comments of the Virginia Corporation Commission," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Virginia), p. 5; "Comments of the Staff of the Indiana Utility Regulatory Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Indiana), p. 9.

2. THE INDUSTRY VIEW OF COST ALLOCATION -- RATE REBALANCING

Local exchange and long distance companies (IXCs) have taken a dramatically different view of cost allocation under the new law. They have argued that basic service rates must be raised to cover their estimates of embedded costs of local service. These estimates of embedded costs of basic service include 100 percent of the loop costs, even though long distance and enhanced services use the loop and a variety of video and other services are likely to use the loop in the future.

The LECs and IXCs claim that there are billions of dollars of "subsidies" embedded in current rates. They calculate this number by comparing current rates for core services -- basic local service -- to the current embedded cost that the local exchange companies claim they incur for these core services.

In arriving at this estimate, most of the LECs and IXCs make a fundamental, flawed assumption about the loop. The LECs and IXCs contend that the costs of the loop should be billed only to core services (i.e. local service) and not to the other services which use the loop. Both the LECs and IXCs claim that the costs of the loop are currently recovered by levying access charges on the IXCs and collecting mark-ups on the prices charged for enhanced services.

The LECs claim that some ratepayers are the beneficiaries of the subsidy, while others are the source of the subsidy. Under the LEC view of the rate structure, ratepayers who receive core services below costs but do not buy a lot of enhanced or long distance services are net winners; those ratepayers who buy a lot of enhanced and long distance services are net losers. The LECs also claim that this pattern of subsidy flows is unsustainable in the face of

competition. They contend that competitors will attack the services and areas priced above cost, cutting off the availability of funds to support below-cost pricing of other services or areas.

The LECs demand that they be kept whole in the transition to competition. If the charges that IXCs pay for the use of the loop are reduced, the LECs want to raise rates for core services dollar-for-dollar. For enhanced services, they want to raise the rates of services they feel are under-priced and lower the rate of services they feel are over-priced (i.e. engage in rate rebalancing). If the LECs are unable to engage in rate rebalancing through regulation or the marketplace, they want to be made whole from a "social fund." Although basic rates are capped in for electing companies for four years we expect LECs to make similar claims in Texas. Therefore, we devote the remainder of this section and the next two sections to an evaluation of the economic, legal and social impact of rate rebalancing.

B. EVALUATING THE LEC ECONOMIC CLAIMS FOR RATE REBALANCING

Underlying the claim for rate rebalancing made by the LECs are economic and legal arguments. The LEC's claim that all of their booked costs for the local exchange service and network access should be recovered in the basic monthly rates for core services. They go on to claim that a vast pool of stranded or potentially stranded costs must also be recovered, either in rates for monthly service or from universal service funds.[23]

The Commission's fourth question frames this debate properly when it recognizes that any cost reallocation and rate rebalancing must be based on careful studies of costs.

---

[23]GTE Oklahoma, "Universal Service in a Competitive Environment," p. 24; SWBT, Initial, p. 24.

4. IF IT IS NECESSARY TO IDENTIFY AND REALLOCATE COSTS AND RATES BEFORE ADDRESSING UNIVERSAL SERVICE SUBSIDIES, WHAT SORT OF INFORMATION WILL BE NEEDED TO ACCOMPLISH THESES TASKS? WHAT TYPE OF COSTS STUDIES SHOULD BE USED AS THE BASIS FOR SUCH REALLOCATION? DO SUCH STUDIES CURRENTLY EXIST OR WILL NEW COSTS STUDIES BE NECESSARY? HAS COMPARABLE INFORMATION BEEN SUBMITTED IN PAST RATE PROCEEDINGS? PLEASE BE SPECIFIC IN YOUR DESCRIPTIONS OF THE INFORMATION NEEDED AND ANY PROCEEDINGS (AND SPECIFIC TESTIMONY) PAST OR NOW UNDERWAY WHICH YOU FEEL ARE APPROPRIATE FOR THIS USE, AND SUGGEST A WAY THAT THE COMMISSION COULD SECURE INFORMATION EFFICIENTLY AND EXPEDITIOUSLY.

We believe that there are two fundamental economic reasons that local exchange rate rebalancing which increases the cost of basic monthly service in anticipation of expanded competition in telecommunications networks is unnecessary and would be anti-competitive.

First, the costs claimed by the LECs are vastly overstated. Any policy which institutionalizes these costs in basic rates would give them a huge windfall of economic resources and reward their strategic investments that were intended to provide competitive and enhanced services.[24] If the Commission rebalances rates to cover investments made in anticipation of competition, or to cover inefficiencies, LECs will be able to recover costs from ratepayers that should either recovered from competitive services, or not at all.

Second, under the new federal law, local exchange companies will be allowed to utilize the very same facilities to deliver a number of new services, including interLATA long distance

---

[24]Two recent public utility commission proceedings underscore this observation, see "Fifteenth Supplemental Order: Commission Decision and Order Rejecting Tariff Revisions: Requiring Refiling," Washington Utilities and Transportation Commission v. U S West, Inc., April 10. 1996, p. 9; and "In Re: U S West Communications Inc.," State of Iowa, Department of Commerce, Utilities Board, Docket No. RPU-95-10, May 17, 1996, p. 26.

and video services. Even if local exchange companies lose some market opportunities to recover their joint and common costs in local markets, they have gained many opportunities in other markets. Rate rebalancing would indemnify these common costs against the very competition that they are supposed to face.

1. THE GROWING EVIDENCE ON THE CAUSE OF THE DIVERGENCE BETWEEN EMBEDDED AND EFFICIENT COSTS

Rigorous cost analysis is necessary to ascertain what the level of costs of an efficient network would be. The claimed costs of local exchange companies have come under increasingly close scrutiny that reveals that these costs are not consistent with the costs that an efficient provider of local telephone service would incur.

There are at least four available models for estimating the cost of providing telephone service efficiently which have been utilized extensively in recent federal and state regulatory proceedings -- the Benchmark Cost Model developed by a consortium of local and long distance companies, the LECOM model, developed by David Gable and generally utilized as expert testimony by Offices of Public Counsel, the Hatfield model which has been utilized by long distance companies, and the proprietary models employed by the LECs.

Table IV-1 shows comparisons between the claimed costs of the local exchange companies and the estimates of costs in a number of states. It is quite clear that substantial differences exist. Commission and third party estimates show differences on the order of $15 to $17 between embedded costs and efficient costs.

It should be stressed that each of the figures included in Table IV-1 is an estimate of the total cost of providing local exchange and network access services. All the joint and common

costs deemed necessary by the modeler to provide local dialtone, local usage and long distance access, as well as enhanced services are included in the estimates. There has been no allocation of costs to other jurisdictions. Thus, in addition to the differences in estimates of the cost of local service, we believe that a substantial part of these costs should be allocated to the non-basic and non-local services which use the network.

2. EXPLAINING THE GAP BETWEEN EMBEDDED AND EFFICIENT COSTS

A number of factors may be contributing to the differences between the LECs' claimed embedded costs and efficient costs including:

- Misreported costs
- Misallocated costs
- Excess profits
- Inefficiencies
- Strategic investment
- Outmoded costs

The PUC is not obligated to ensure or even allow the recovery of misallocated or inefficient costs or strategic investment. None of these costs deserves support from the universal service fund.

TABLE IV-1
ESTIMATES OF TSLRIC COMPARED TO EMBEDDED COSTS ($/MONTH)

AREA	THIRD PARTY		BCM		ARMIS
	SOURCE	AMT	MCI	ARMIS	EMB.
NATIONAL	HATFIELD I	21.35	16.71	23.04	32.96
	HATFIELD II	17.25			
PA	HATFIELD I	18.34	14.67	20.24	30.16
	HATFIELD II	15.08			
UT	HATFIELD I	14.83	15.09	28.01	37.93
	HATFIELD II	16.45			
CO	HATFIELD I	15.83	18.71	25.80	35.72
	HATFIELD II	17.84			
CA	HATFIELD I	14.94	13.09	18.05	27.97
	HATFIELD II	13.49			
WA	COMMISSION	10.50	17.02	23.48	33.40
	HATFIELD I	11.15			
FL	COMMISSION	19.00	14.79	20.40	30.32
	HATFIELD II	17.11			
IN	LECOM	18.22	14.93	20.58	30.50
	HATFIELD II	16.63			
ME	LECOM	22.96	24.83	34.24	44.16
	HATFIELD II	19.32			
IA	COMMISSION	15.55	22.90	31.58	41.50
	HATFIELD II	16.33			
TX	HATFIELD II	16.96	18.23	25.14	35.06

NOTES: See text for a description of the cost estimates and what they contain.

SOURCES:

NATIONAL: BCM - Benchmark Cost Model: A Joint Submission by MCI Communications Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc., CC Docket No. 80-286, December 1, 1995.

Hatfield: I - Hatfield Associates Inc., The Cost of Basic Universal Service, July 1994, p. 4; II -Hatfield Associates Inc., The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, March, 1996.

ARMIS EMBEDDED - "Comments U S West Inc.," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, Schedule 3. MCI, Sprint, USW and NYNEX Benchmark Cost Model, CC Docket No. 80-286, December 1, 1995.

STATES:

ALL HATFIELD II: Hatfield and Associates, Hatfield Model: Version 2.2, Release 1, May 30, 1996, included as Appendix D to Reply Comments of AT&T

PA - "Hatfield Associates, Inc. on Behalf of MCI Telecommunications Corporation and AT&T Communications of Pennsylvania, A Model for Determining the Cost of Basic Universal Service in Pennsylvania," before the Pennsylvania Public Utility Commission, Advanced Notice of Proposed Rulemaking RE Formal Investigation To Examine and Establish Updated Universal Service Principles and Policies for Telecommunications Services in the Commonwealth, Docket No. L-009050102, July 17, 1995, Attachment 10.

UT - "Direct Testimony of Robert A. Mercer, AT&T Communications of the Mountain States," before the Public Service Commission of Utah, In the Matter of the Request for Agency Action of Phoenix Fiberlink of Utah Inc. for Authority to Provide Intrastate Telecommunications Services in the State of Utah. In the Matter of the Application of Electric Lightwave Inc. for Authority to Compete as a Telecommunications Corporation and to Offer Public Telecommunications Services. In the Matter of an Investigation into Co-Location and Expanded Interconnection. U S West Communications (USWC) Advice Letter 95-16. Docket Nos. 95-2206-01, 94-22-2-01, 94-999-01, 95-049-T16, Attachment 3.

CO - "Direct Testimony of Robert A. Mercer, AT&T Communications of the Mountain States and MCI Telecommunications Corporation" before the Public Utility Commission of the State of Colorado, In the Matter of Proposed Rules Regarding Implementation of S. 40-15-101, ET SEQ -- Requirements Relating to Universal Service and the Colorado High Cost Fund, Docket No. 95R-558T, February 2, 1996, Attachment 3.

CA - "Testimony of Robert A. Mercer on Behalf of AT&T Communications of California, Inc. (U 5002 C) and MCI Telecommunications Corporation (U 5011 C)," before the Public Service Commission of the State of California, Rulemaking on the Commission's Own Motion into Universal Service and to Comply with the Mandates of Assembly Bill 3643. Investigation on the Commission's Own Motion into Universal Service and to Comply with the Mandates of Assembly Bill 3643, Docket Nos. R.95-01-020 and 021, April 17, 1996, Attachment 4A.

WA - "Direct Testimony of Robert A. Mercer, AT&T Communications of the Pacific Northwest, Inc." Washington Utilities and Transportation Commission v. U S West, Inc., Docket No. UT-950200, August 11, 1995, Attachment 3A.

FL - "Order No. PSC-95-1592-FOF-TP," before the Florida Public Service Commission, In Re: Determination of funding for Universal Service and Carrier of Last Resort Responsibilities,

Docket No. 950696 - TP, December 27, 1995, p. 32, states that "The record demonstrates that Southern Bell's average cost for a residential line is "somewhat less than $19 a month.'"

WA - "Fifteenth Supplemental Order: Commission Decision and Order Rejecting Tariff Revisions: Requiring Refiling," Washington Utilities and Transportation Commission v. U S West, Inc., April 10. 1996, p. 9 states, "USWC's own data show little cost difference between its rural and urban service territories. The Commission directs the Company to eliminate extended area service surcharges and establish a statewide residential rate of $10.50 per month, the average i effect today. The $10.50 rate covers the cost of local residential service and provides a substantial contribution to shared and common costs.

LECOM: IN - David Gable, Current Issues in the Pricing of Voice Telephone Services (American Association of Retired Persons, 1995), p. 17, and "Testimony of David Gable, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part Its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole Its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075;

LECOM: ME - "Testimony of David Gable," State of Maine Public Utilities Commission, Re: Investigation Into Regulatory Alternatives for the New England Telephone Company's,Docket No. 94-123 and Frederic A. Pease, Et. Al. V. New England Telephone Company Requesting Commission Investigation of the Level of Revenues Being Earned by NET and Determination of Whether Toll and Local Rates Should be Reduced, Docket No. 94-254, December 13, 1994, Exhibit 2. An earlier version of this table included an estimate of the long run incremental cost, not the total service long run incremental cost of local exchange service.

IA: "In Re: U S West Communications Inc.," State of Iowa, Department of Commerce, Utilities Board, Docket No. RPU-95-10, May 17, 1996, p. 26.

Table IV-2 presents two estimates of the importance that these factors play in explaining the gap between embedded costs and the cost of providing efficient telephone services. One estimate uses materials from a rate case in Indiana, which saw extensive evidence on cost analysis developed. That case was settled with a rate reduction for local service of approximately $3.00 per month, including the elimination of the state subscriber line charge.

The second estimate uses recent national numbers developed primarily for the FCC's universal service and local competition proceedings. Both show that the gap can be readily explained by four factors.

Excess profits are a primary source of the problem. In the Indiana case, the company's underlying cost model relied on a cost of money of 12.67 percent. The People's Counsel estimated the cost of money at less than 10 percent. At the national level, we have documented excessive profits for local exchange companies on the order of $5 to $6 billion for the past several years.[25] Including tax effects, this equates to approximately $5 per month.

Strategic costs are a second major component of the gap. These are assets deployed primarily to meet demand in competitive segments or non-telecommunications businesses. The FCC has recently recognized that this is a massive problem, with huge quantities of underutilized fiber and switching capacity deployed throughout the network.[26] In Indiana, the People's Counsel conducted a close review of the allocators used to assign costs to the residential class and found gross overallocation of plant to that category.[27] Among the major categories of strategic investment were pair gain technology to enhance Centrex offerings (also identified at the national level as a problem), system signalling seven and ISDN costs primarily meeting business needs, switching costs allocated on the basis of average use, rather than peak use. These analyses demonstrate that between 10 and 20 percent of the total plant in service has been deployed for these strategic investments. This works out to between $3.00 and $4.00 per month.

---

[25]Mark N. Cooper, Milking the Monopoly: Excess Earnings and Diversification of the Baby Bells Since Divestiture, (Consumer Federation of America, February 1994)

[26]Similar conclusions are reached in "Testimony of Richard Gable," Appendix VII, State of Maine, Public Utilities Commission, Re: Investigation Into New England Telephone Company's cost of Service and Rate Design, Docket No. 92-130

[27]"Testimony of Harold L. Rees, Public's Exhibit No. 3," p. 44, both in State of Indiana, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075

TABLE IV-2
RECONCILING EMBEDDED COSTS WITH EFFICIENT COSTS
LOCAL RESIDENTIAL TELEPHONE SERVICE

	INDIANA	NATIONAL
	(a)	(b)
1. EMBEDDED COST	30.25	33.00
	(c)	(d)
2. EXCESS PROFIT	2.25	5.00
	(c)	(e, f)
3. STRATEGIC INVESTMENT	3.00	3.00
	(c)	(f)
4. INEFFICIENCY	4.00	4.00
	(c)	(c)
5. MISALLOCATED TOLL	4.50	4.50
	(c)	(g)
ENHANCED/BUSINESS	1.00 - 2.00	6.00
6. LOCAL RESIDENTIAL COST OF SERVICES [1-(2+3+4+5)]	13.50 - 14.50	10.50
	(h)	(i)
TSLRIC ESTIMATES	14.93 - 18.22	16.71 - 21.35
	(a)	(j)
LOCAL RATES (EXCLUDING TAXES)	15.35	16.80

SOURCES: See text for discussion.

(a) Converted to a Monthly per line basis from "Testimony of Trevor R. Roycroft, Public's Exhibit 1," pp. 134-136, in State of Indiana, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075

(b) "Comments of U S West, Inc.," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, Schedule 3.

(c) "Testimony of Harold L. Rees, Public's Exhibit No. 3," p. 44, both in State of Indiana, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075

(d) Mark N. Cooper, Milking the Monopoly: Excess Earnings and Diversification of the Baby Bells Since Divestiture, (Consumer Federation of America, February 1994)

(e) Lee Selwyn, Analysis of Incumbent LEC Embedded Investment (ETI, May 1996), Table 6; Kenneth C. Baseman and Harold V. Gieson, Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by Local Exchange Carriers (MiCRA, December, 1995).

(f) Hatfield Associates, The Cost of Basic Network Elements: Theory Modeling and Policy Implications, March 1996, Table 5.

(g) Susan M. Baldwyn and Lee L. Selwyn, The Cost of Universal Service: A Critical Assessment of the Benchmark Cost Model (ETI, April, 1996), p. 76, shows approximately 20 percent of operating expenses resulting from the acceleration of depreciation due to pursuit of competitive and business services and marketing expenses targeted at business services.

(h) David Gable, Current Issues in the Pricing of Voice Telephone Services (American Association of Retired Persons, 1995), p. 17, and "Testimony of David Gable, Indiana Utility Regulatory Commission, In the Matter of a Petition of Indiana Bell Telephone and Telegraph Company, Incorporated, for the Commission to Decline to Exercise in Part Its Jurisdiction over Petitioner's Provision of Basic Local Exchange Service, to Utilize Alternative Regulatory Procedures for Petitioner's Provision of Basic Local Exchange Service and Carrier Access Service, and to Decline to Exercise in Whole Its Jurisdiction Over All Other Telecommunications Services and Equipment Pursuant to IC 8-1-2-6, Cause No. 39075; BCM -Benchmark Cost Model: A Joint Submission by MCI Communications Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc., CC Docket No. 80-286, December 1, 1995. Hatfield II - Hatfield Associates Inc., The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, March, 1996.

(i) Hatfield: I - Hatfield Associates Inc., The Cost of Basic Universal Service, July 1994, p. 4; II -Hatfield Associates Inc., The Cost of Basic Network Elements: Theory, Modeling and Policy Implications, March, 1996. BCM - Benchmark Cost Model: A Joint Submission by MCI Communications Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc., CC Docket No. 80-286, December 1, 1995.

(j) Industry Analysis Division, Common Carrier Bureau. Trends in Telephone Service (Federal Communications Commission, May 1996), Table 6.

The third major category of costs that fill the gap between embedded and efficient costs are inefficiencies. These are primarily made of extremely large overhead loading assigned to residential and basic service (including marketing and general corporate expenses). Both the Indiana People's Counsel and the national estimates place this figure at approximately 15 percent of the claimed revenue requirement. This works out to roughly $3.00 to $4.00 per month.

As previously noted, consumer advocates, state regulators, and some companies believe that there is another major category of cost misallocation. Long distance and enhanced services utilize the network and must either have costs attributed to them or have their revenues included in the cost/revenue calculation. The Indiana People's Counsel claimed that 30 percent of total costs should be allocated to the toll market.

Since most cost/revenue comparisons include the federal subscriber line charge, we believe that half of the Indiana People Counsel's estimate remains misallocated. That is, the costs associated with loop facilities used by interLATA long distance are included in the cost estimates. This is compensated by the fact that the revenue associated with those uses (the EUCL) are generally included in the estimation of basic service revenues.[28] Thus, approximately $4.50 should be taken into account either as a cost or as a revenue (CCL plus intraLATA long distance). The $4.50 would be equal to the national average CCL charge of $2.50, plus at least another $2 for intraLATA toll use of the network.

[28]The Indiana People's Counsel points out that CCL revenues should also be included, since these cover the cost of the use of the loop.

Similarly, some of the costs of the network have been incurred to provide enhanced services. The Indiana People's Counsel identified at least $1.30 of enhanced service revenues which should be attributed to local to offset these cost.

Including these as cost adjustments for comparison with the TSLRIC studies is appropriate since those studies include switching and transport costs that are appropriately sized for local traffic, not long distance. Although TSLRIC studies include the full range of functionalities associated with all services that can be provided over the network (local, long distance and enhanced) strive to exclude the marketing and other expenses (like marketing costs) associated with these services.

C. CONCLUSION

The bottom line on Table IV-2 is legitimate costs of local services. As the Washington and Iowa Commissions have recently found and the settlement in the Indiana case indicates, these costs are covered by local rates. In summary, there is simply no basis for the claim that embedded costs should provide the basis for radical rate rebalancing or that universal service requires rate rebalancing. Even in a competitive market, the local exchange companies will be able to recover the costs of efficiently provided local service.

Because rate rebalancing could have an extremely large impact on the price of basic service and there is such strong evidence that the claimed embedded costs are far above efficient costs, the Commission must take a very hard look at the cost/price data underling proposals for rate rebalancing. As described in Section VIII, PURA 95 is inconsistent in its treatment of cost analysis and data. On the one hand, the law clearly intends to ensure reasonable rates (i.e. rates

the do not embody excess profits) for efficient services (inefficiencies should not be included) that are fair and free of cross subsidies and not anti-competitive (i.e. must not allow prices below incremental costs or services to use facilities for free).[29] On the other hand, the law does not subject telephone company cost studies to thorough regulatory oversight for at least some purposes.[30] For the purposes of Subtitle J: Competitive Safeguards, costing and pricing cannot be subjected to a contested case, although for other purposes under PURA 95, there is no prohibition on contested cases. We believe that any proposal to rebalance rates should be subject to a contested case and should not be considered under Subtitle J.

V. THERE IS NO LEGAL BASIS FOR RATE REBALANCING AND STRANDED COST RECOVERY

The local exchange companies invariably link universal service, rate rebalancing and stranded investment together.

> Under this regulatory compact, the Company has been assured full recovery of all its prudently incurred investments over a longer period of time than what is required in a competitive marketplace. This situation existed to keep basic exchange service rates lower in order to accomplish the Commission's universal service goal.[31]

The Commission should also reject the premature and unfounded claims that are likely to be made about stranded investment.

---

[29]See Section VIII below for a discussion of these principles in the law.

[30]PURA §3.457.

[31]GTE Oklahoma, "Universal Service in a Competitive Environment," p. 24. See also, SWBT Initial, p. 24.

A. NEW OPPORTUNITIES TO RECOVER COSTS

The fact that the difference between embedded costs and efficient costs can be largely explained by excess profits, inefficiencies and strategic investments, actually suggests that we should expect to see these costs competed away as competition increases. They should not be shifted onto basic services, which are likely to be the least competitive of all services.

Moreover, a large part of these costs may actually be recovered, legitimately, in new markets. Many of the strategic investments and much of the excess capacity has been deployed to support advanced busine and video services. These markets will be made more readily available under the 1996 Act.

As Table V-1 shows, the markets which have been opened to local exchange companies equal or exceed the current markets in which these companies provide services. It is absolutely clear that the opportunities they gain equal or outweigh any additional risk they encounter. Not only has the long distance market been opened to the LECs, but entry into the cable market has been eased. Moreover, the cessation on approval of 1-plus competition for intraLATA long distance actually protects one of their markets from competition in the near-term.

It is even more important to realize that the very joint and common costs that the LECs claim they could not recover under the FCC's contemplated pricing approach to unbundling of network facilities, they could easily recover in the new lines of business. For example, the most highly developed video dialtone proposals submitted to the FCC showed that joint and common costs between video and telephony would be in the range of 60 to 75 percent. Certainly long distance service will entail at least this level of joint and common costs. Excess switching capacity and fiber trunking can be used to provide long distance service. Efforts by several of the companies to merge will assist in the utilization of these strategically deployed facilities to enter the long distance market.

TABLE V-1:
LEC RISK AND REWARD IN THE 1996 TELECOMMUNICATIONS ACT:
(Billions of Dollars)

	GREATER RISK	GREATER REWARD/LESS RISK
LOCAL EXCHANGE	42	
PRIVATE LINE, CELLULAR, MISC. ACCESS	35	
INTRALATA		13
CABLE		21
INTERLATA		67
MANUFACTURING		10
TOTAL	101	111

SOURCES: Industrial Analysis Division, Trends in Telephone Service, Federal Communications Commission, May 1996, Tables 30, 31, 32; U.S. Department of Commerce, Industrial Outlook: 1994, estimate of telecommunications network equipment.

B. STRANDED INVESTMENT

The case which the LECs cite most often as the basis for their legal argument for stranded investment is Duquesne Light Company v. Barisch.[32] In their discussion, the LECs have missed one important point, the utility lost the case. Although the justices made many

[32]Duquesne Light Company v. Barisch, 109 S. Ct. 609 (1989).

pronouncements about how regulators should treat utilities, in the end, they found that there was no taking and the utility should not recover the costs it was claiming.

The facts of that case were actually much more favorable to the utility than the facts the Commission is likely to encounter in any takings case brought by a local telephone company. In that case there were specific costs associated with a nuclear power plant that was built and which the company claimed was a prudent cost. A Pennsylvania appeals court disallowed recovery and the Supreme Court upheld their decision.

The utility in that case had no opportunity to recover the costs which had been disallowed, but the Supreme Court upheld the lower courts decision anyway. Under the 1996 Act, the LECs have massive revenue opportunities in markets which were previously closed to them. The arguments for a taking under the 1996 Act, therefore, are far weaker than the failed arguments made by the utility in Duquesne.

Up front revenue replacement for lost opportunities and compensation for stranded investment lacks any empirical, theoretical and legal justification.

1. Empirical Analysis Does Not Support the Claim for Revenue Replacement and Compensation for Stranded Investment

There is no reason for the Commission to conclude that stranded investment currently exists. There is no reason to believe that every asset deployed by the companies was deployed to meet a social obligation. There is no reason to believe that the value of every asset which has not been fully depreciated when technology renders it obsolete was undermined by a social policy of underpricing. On the other hand, there is good reason to believe that the companies have already been substantially compensated for any risks of underrecovery of the value of the assets they wish to declare stranded.

There is no reason that the Commission should conclude that stranded investment will soon exist. There is no demonstration that assets will underperform and revenue deficiencies will develop as a result of regulatory changes. There is no demonstration that assets will underperform or that revenue deficiencies will develop as a result of whatever market changes take place.

There is no reason that the Commission should conclude that, even if some investment is stranded, a new regulatory mechanism must be implemented to handle it. There is no demonstration of any company specific revenue deficiency in the aggregate. There is not even a demonstration of a revenue deficiency in the specific exchanges which are said to be creating the social obligation.

2. Economic Theory Does Not Support the Claim for Revenue Replacement and Compensation for Stranded Investment

Allowing LECs the right to claim and recover "stranded" investment is not necessary to ensure the confidence of capital markets in LEC investments. The write off of assets is a frequent occurrence in competitive industries. Although investors would like social insurance funds to ensure them against the stranding of any investment, they understand the risks and rewards and do not require such funds for all investment. These risk premiums have already been reflected in the handsome returns earned by incumbent local exchange companies.

These costs would not be recovered in a competitive marketplace nor should they be recovered under any reasonable theory of economic regulation.

- A persistent pattern of excess profits earned by the LECs has existed for a decade.